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Supreme Court of the United States

OCTOBER TERM, 1992

MUSICK, PEELER & GARRETT, LEONARD CASTRO, ROBERT SCHUCHARD, J.H. COHN & CO., ED BACANI and ROBERT TORKAR,

Petitioners,

—v.—

EMPLOYERS INSURANCE OF WAUSAU and FEDERAL INSURANCE COMPANY,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES ii

PRELIMINARY STATEMENT 1

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE* .. 2

SUMMARY OF ARGUMENT 3

ARGUMENT 5

I. PUBLIC POLICY REASONS STRONGLY SUPPORT ALLOWING A RIGHT TO CONTRIBUTION UNDER SECTION 10(b) AND RULE 10b-5 5

A. Fundamental Fairness Requires an Allowance for 10b-5 Contribution 6

B. Contribution Promotes the Policy of Deterrence 13

C. Contribution Does Not Discourage Settlement or Impair Judicial Efficiency 16

II. PROPORTIONAL FAULT IS THE BEST APPROACH TO THE ALLOCATION OF DAMAGES IN 10b-5 ACTIONS 19

CONCLUSION 28

TABLE OF AUTHORITIES

Cases **PAGE**

Aaron v. SEC, 446 U.S. 680 (1980) 12 n.6

Alfus v. Pyramid Tech. Corp., No. 89-20184 (N.D. Cal. Feb. 20, 1991) (settlement reported in 14 Class Action Rep. 525-26 (1991)) 26

Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540 (D. Colo. 1989), *appeal dismissed as moot*, 936 F.2d 582 (10th Cir. 1991) 21-24

Arata v. Nu Skin Int'l, Inc., No. 91-2811 (N.D. Cal. Jan. 31, 1992) (settlement reported in 15 Class Action Rep. 158 (1992)) 26

Baker v. B.P. America, Inc., 749 F. Supp. 840 (N.D. Ohio 1990) 13

Berley v. Sculley, No. 91-20270 (N.D. Cal. Feb. 27, 1992) (settlement reported in 15 Class Action Rep. 153 (1992)) 26

Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) 10

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 5, 17

Cooper Stevedoring Co. v. Fritz Kopke, Inc., 417 U.S. 106 (1974) 7

DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990) 11

Elbaor v. Smith, 36 Tex. Sup. Ct. J. 245 (Dec. 2, 1992)... 17

First Fed. Sav. & Loan Ass'n v. Oppenheim, Appel, Dixon & Co., 631 F. Supp. 1029 (S.D.N.Y. 1986) 24 n.8

PAGE

Franklin v. Kaypro Corp., 884 F.2d 1222 (9th Cir.), *cert. denied*, 111 S. Ct. 232 (1990) ..... 21-27 & n.10

Globus, Inc. v. Law Research Serv., Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971) 13

Gomes v. Brodhurst, 394 F.2d 465 (3d Cir. 1967) 7

Gould v. American Hawaiian Steamship Co., 387 F. Supp. 163 (D. Del. 1974), *vacated on other grounds*, 535 F.2d 761 (3d Cir. 1976) 13, 20

Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983) 18

In re Beverly Hills Sav. & Loan Ass'n Sec. Litig., No. 85-3157 (C.D. Cal. June 13, 1991) (settlement reported in 14 Class Action Rep. 314 (1991)) 26

In re Brichard Sec. Litig., No. 87-2987 (N.D. Cal. Mar. 27, 1991) (partial settlement reported in 15 Class Action Rep. 152 (1992)) 26

In re Cineplex Shareholders Litig., No. 89-2461 (C.D. Cal. 1991) (settlement reported in 14 Class Action Rep. 526 (1991)) 26

In re Digital Sound Corp. Sec. Litig., No. 90-3533 (C.D. Cal. Jan. 31, 1991) (settlement reported in 14 Class Action Rep. 330 (1991)) 27

In re Jiffy Lube Sec. Litig., 927 F.2d 155 (4th Cir. 1991) ..... 27 & n.11

In re Kingston Cotton Mill Co., 2 Ch. 279 (1896) 9

PAGE

In re Precious Metals Dealers Litig., No. 90-5124 (C.D. Cal. Feb. 24, 1992) (partial settlement reported in 15 Class Action Rep. 145 (1992)) 26

In re Rykoff-Sexton Sec. Litig., No. 90-0689 (C.D. Cal. Nov. 13, 1991) (settlement reported in 15 Class Action Rep. 145 (1992)) 26

In re Technical Equities Fed. Sec. Litig., No. C-86-20157 (N.D. Cal. Nov. 17, 1989) (settlement reported in 14 Class Action Rep. 315-16 (1991)) 26-27

In re U.S. Grant Hotel Assoc. Ltd. Sec. Litig., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,703 (S.D. Cal. Nov. 6, 1990) 26

In re Xoma Corp. Sec. Litig., Nos. 92-2252 (N.D. Cal. May, 20, 1992) (settlement reported in 15 Class Action Rep. 147 (1992)) 26

Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773 (1991) 3, 5

McLean v. Alexander, 449 F. Supp. 1251 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) 20

Nelson v. Bennett, 662 F. Supp. 1324 (E.D. Cal. 1987) ... 22

Professional Beauty Supply, Inc. v. National Beauty Supply, Inc., 594 F.2d 1179 (8th Cir. 1979) 6

River Garden Farms, Inc. v. Superior Court, 103 Cal. Rptr. 498 (Ct. App. 1972) 22

Rolf v. Blythe, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.) *cert. denied*, 439 U.S. 1039 (1978) 12

Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987) ..20, 27 n.11

PAGE

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United States v. Reliable Transfer Co., 421 U.S. 397 (1975) 7, 18, 20, 21, 23

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Statutes and Rules

Securities Act of 1933
§ 11, 15 U.S.C. § 77k(f) 19

Securities Exchange Act of 1934
§ 10(b), 15 U.S.C. § 78j(b) ..... *passim*

Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... *passim*

17 C.F.R. § 201.2(e)(ii) 15

Federal Rules of Civil Procedure
Rule 23(e) 27 n.11
Rule 49 19

Legislative History

138 Cong. Rec. S12604 (daily ed. Aug. 12, 1992) (statement of Sen. Sanford on S. 3181, Securities Private Enforcement Act of 1992) ..... 8 & n.4

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PAGE

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PAGE

Lochner, *Black Days for Accounting Firms*, WALL ST. J., May 22, 1992, at A10, col. 4 10

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McLeod, *Claims Help Sink Laventhol; Virtually All E & O Coverage Depleted*, BUS. INS., Nov. 26, 1990, at 2 ...9 n.5

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Roszkowski & Prentice, *Reconciling Comparative Negligence and Strict Liability: A Public Policy Analysis*, 33 ST. LOUIS U. L.J. 19 (1988) 19

WHO AUDITS AMERICA 393-96 (Data Fin. Press, 25th ed. June 1991) 14 n.7

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PRELIMINARY STATEMENT

Pursuant to Rule 37.3 of the Rules of this Court, the American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as *amicus curiae* in support of the position of the respondents that there exists an implied right of action for contribution under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5. This brief is

submitted on written consents of the parties, which have been filed contemporaneously herewith.

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the national professional accounting organization, all of whose more than 300,000 members are certified public accountants. Among the Institute's purposes are the promotion and maintenance of high professional standards of practice. In the pursuit of those ends, the Institute has come to be accepted as the authoritative source of standards and procedures in the accounting profession.

As the issuer of these standards, the Institute has a profound interest in the scope and bases of civil liability sought to be imposed upon accountants and auditors under Section 10(b) of the 1934 Act and Rule 10b-5.[1] The Institute also has a profound interest in the availability and contours of the right of defendants to seek contribution under Section 10(b) and Rule 10b-5. Accountants are routinely named as defendants in 10b-5 actions, merely on the basis of their having independently audited the financial statements of their clients. Even though they are typically less responsible than their clients and other affiliated persons, who ultimately control the financial reporting process, accountants are often viewed as preferred defendants by disgruntled investors searching for the most solvent "deep pocket" they can find when their investments turn sour. Without a right of contribution, accountants may be required to

1 The Institute was invited to and did submit a position paper to the United States Senate concerning the proposed scope of civil liabilities and damages under the 1934 Act. *Hearings on S. Res. 84 (72d Cong.), S. Res. 56, and S. Res. 97 Before the Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 7207-10 (1934). In addition, this Court has permitted the Institute to file briefs as *amicus curiae* on related securities law issues in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Aaron v. SEC*, 446 U.S. 680 (1980); and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

bear the bulk of the burden while the primarily responsible parties pay little or nothing.

Because of its disproportionate exposure to liability under Section 10(b) and Rule 10b-5, the accounting profession is greatly disturbed by petitioners' request that this Court overrule a quarter-century of well-settled law permitting defendants to seek contribution in cases brought under Section 10(b) and Rule 10b-5. Such a result would dramatically increase the likelihood that accountants will incur liability wholly out of proportion to their relative responsibility in pending and future cases under Section 10(b) and Rule 10b-5, and thus would have a substantial detrimental impact upon the accounting profession.

SUMMARY OF ARGUMENT

In order not to burden the Court with matters that have already been brought to its attention by the parties to this action, the Institute will not address in this brief the legal arguments concerning whether Congress would have provided for a right of contribution under Section 10(b) had the question arisen. In short, the Institute submits that the answer to this question is plainly yes, given that Congress specifically provided for a right of contribution under the most comparable express provisions of the 1934 Act. Accordingly, following its highly analogous opinion in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773 (1991), the reasoning of which is virtually dispositive here, the Court should similarly look to the express contribution provisions of the 1934 Act as a basis for implying a right of contribution for the 10b-5 implied cause of action.

The Institute also hereby joins in the legal arguments presented by respondents Peat Marwick Main & Co. and K.M.G. Main Hurdman demonstrating the propriety of a right of contribution in Section 10(b) actions. Rather than reiterate those arguments here, the Institute will focus on the pertinent policy

considerations in the event the Court deems it appropriate to consider them. While the Court need not balance the relevant policies in order to recognize a Section 10(b) right of contribution (since Congress has already done so in electing to permit contribution under the comparable express provisions of the 1934 Act), it is significant that all of the relevant policy considerations strongly favor recognition of such a right.

First, contribution is essential to effectuate the principle of fairness. The typical 10b-5 action involves multiple defendants of varying degrees of responsibility, and it is both inequitable and irrational to require one or more defendants to bear the entire loss while other, more responsible parties escape liability altogether. Indeed, given the inviting presence of deep pocket targets such as accounting firms and other outside professionals, plaintiffs may elect not to sue the most responsible persons at all, which only exacerbates the unfairness of a no-contribution rule. Such a rule is particularly unfair to accounting firms, whose virtually limitless potential liability for auditing their clients' financial records is vastly disproportionate both to their relative responsibility and to the compensation they receive.

Second, contribution promotes the policy of deterrence that underlies the federal securities laws. Without the threat of a contribution action, corporate insiders may be more willing to engage in misconduct on the assumption that potential plaintiffs will bypass them in favor of pursuing the deep pocket outsiders. With contribution, all potential defendants know that they may be responsible for a portion of the damages, regardless of whether the plaintiff elects to sue or pursue them.

Third, contrary to the arguments of its opponents, contribution neither discourages settlements nor impairs judicial efficiency. The available empirical evidence indicates that nearly all 10b-5 actions have settled, and continue to settle, notwithstanding the availability of contribution. The only settlements which a rule of contribution inhibits are those which are collusive or patently unfair to non-settling defendants.

Finally, while the question of the method of apportioning damages among parties seeking contribution is not before the Court, the Institute considers it necessary to respond here to the arguments that have been advanced by *amicus curiae* National Association of Securities and Commercial Law Attorneys ("NASCAT") against the adoption of a "proportional" or "comparative" fault approach. Contrary to NASCAT's arguments, the proportional fault approach to the apportionment of damages in 10b-5 actions is by far the most efficacious one in promoting the policies of fairness and deterrence which underlie the right of contribution.

ARGUMENT

I.

PUBLIC POLICY REASONS STRONGLY SUPPORT ALLOWING A RIGHT TO CONTRIBUTION UNDER SECTION 10(b) AND RULE 10b-5.

If, as the Institute urges, the Court concludes that had Congress adopted an express Section 10(b) cause of action it "would have balanced the policy considerations" implicit in any rule of contribution in the same manner as it did in the comparable provisions of the 1934 Act, then the inquiry "should be at an end." *Lampf*, 111 S. Ct. at 2780. Alternatively, while it is unnecessary to do so in order to recognize a right of contribution, the Court may elect to weigh "what may be described as policy considerations" in fleshing out the parameters of the 10b-5 cause of action. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975); *cf. Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749, 2764 (1991) (Court has power to "round[ ] out" the substance of an existing implied right of action to ensure fair application of the law).

While petitioners and their *amicus* have undertaken a forced effort to invoke public policy reasons for denying a right to contribution, their arguments are unpersuasive. As the over-

whelming majority of courts and commentators have concluded, time and again after thorough consideration, the pertinent policy considerations strongly favor allowance of a right of contribution. As one particularly thorough commentary recently observed:

> Alone or together, the most common arguments simply do not support a denial of contribution. These arguments have been debated repeatedly over the past sixty years and in jurisdiction after jurisdiction the pro-contribution position has prevailed. Indeed, it has been transformed from an "exception to the rule" into a "vibrant and complex facet of the law."

Langmore & Prentice, *Contribution Under Section 12 of the Securities Act of 1933: The Existence and Merits of Such a Right*, 40 EMORY L.J. 1015, 1098 (1991).

For sound policy reasons, contribution has been an integral part of litigation under Section 10(b) and Rule 10b-5 for nearly twenty-five years. A careful analysis of the policy considerations applicable to the right of contribution under those provisions supports a continuation, rather than destruction, of this long-accepted and highly important right.

A. Fundamental Fairness Requires an Allowance for 10b-5 Contribution.

Probably the most compelling justification for permitting contribution in Rule 10b-5 actions is that simple fairness requires it. Numerous parties with varying degrees of responsibility for a Section 10(b) violation may be pronounced liable by a finder of fact, and it is unfair to require one or more of such defendants to bear the entire loss while others escape liability altogether. *See Professional Beauty Supply, Inc. v. National Beauty Supply, Inc.*, 594 F.2d 1179, 1185-86 (8th Cir. 1979) ("There is an obvious lack of sense and justice in a rule which permits the entire burden of restitution of a loss for which two parties are responsible to be placed upon one alone because of the plaintiff's whim or spite, or his collusion with

the other wrongdoer"); *Gomes v. Brodhurst*, 394 F.2d 465, 467-68 (3d Cir. 1967) ("There is no longer a legitimate place in our system, if, indeed, there ever was, for a rule of law which places the full burden of restitution upon one who is only in part responsible for a plaintiff's loss. Such a philosophy stems from a more ancient day which more easily intermingled penal and compensatory considerations.").

This Court's prior decisions recognize this same principle. For example, in *Cooper Stevedoring Co. v. Fritz Kopke, Inc.*, 417 U.S. 106, 111 (1974), the Court recognized a right of contribution among joint tortfeasors in admiralty cases, reasoning that "a 'more equal distribution of justice' can best be achieved by ameliorating the common-law rule against contribution which permits a plaintiff to force one of two wrongdoers to bear the entire loss, though the other may have been equally or more to blame." And in *United States v. Reliable Transfer Co.*, 421 U.S. 397 (1975), the Court adopted the doctrine of comparative negligence in maritime cases in order to promote "the 'just and equitable' allocation of damages," adding that "worldwide experience has taught that that goal can be more nearly realized by a standard that allocates liability for damages according to comparative fault whenever possible." *Id.* at 411. Neither the simplicity nor the intuitive appeal of this principle renders it any less compelling.

The harshness of a no-contribution rule is greatly exacerbated when a minimally culpable party must bear most or even all of the economic liability, while more culpable parties pay little or nothing—or may not even be sued at all. Indeed, a no-contribution rule virtually assures that Rule 10b-5 actions will often produce such an unfair result, since "[n]umerous parties with varying degrees of participation in the fraudulent scheme may be responsible for a violation of section 10(b)." Adamski, *Contribution and Settlement in Multiparty Actions Under Rule 10b-5*, 66 IOWA L. REV. 532, 541 (1981).

The typical multi-party 10b-5 lawsuit involves, broadly speaking, two groups of defendants—corporate issuers of securities and their director/managers, on the one hand ("corporate insiders") and the corporation's outside professional advisors, on the other.[2] Among the outside advisors habitually named by plaintiffs as 10b-5 defendants are accountants who have performed an independent audit of the client corporation's financial statements.[3] A rule denying contribution in 10b-5 actions would be particularly unfair to accounting firms, which have come to bear the brunt of an epidemic of securities litigation that is spreading throughout the accounting profession and the business community.

In 1990 and 1991, a record 614 securities class action suits were filed in the federal courts, exceeding the total number of similar suits filed in the previous five years. *See* 138 Cong. Rec. S12604 (daily ed. Aug. 12, 1992) (statement of Sen. Sanford on S. 3181, Securities Private Enforcement Act of 1992).[4] Given the high concentration of these lawsuits on a relatively small number of accounting firms, the impact of this litigation explosion upon the accounting profession has been "particularly acute," *id.*, and has resulted in virtually limitless liability,

2 There are, of course, other common varieties of multi-party 10b-5 litigation, such as customer "churning" suits against securities brokers and their brokerage firm employers. Moreover, certain groups of defendants, such as outside directors, can share some characteristics of both corporate insiders and outside advisors. Nevertheless, the statement in text is a useful generalization for purposes of discussion.

3 Attorneys and underwriters are among the other frequently-targeted outside advisors in 10b-5 actions.

4 As pointed out by Senator Sanford, there is no evidence that this increase in lawsuits corresponds to a similar increase in the incidence of securities fraud. To the contrary, the final outcome of all 10b-5 actions filed against the largest six accounting firms which concluded in 1991 shows that the total amount of settlements and judgments paid by the firms was only 3 percent of the claimed damages, and that in 83 percent of the cases the firms had to pay $8 in legal fees for every $1 ultimately paid to the plaintiffs. *See* 138 Cong. Rec. at S12605.

high insurance premiums and the increasing unavailability of insurance. *See, e.g.*, Gossman, *The Fallacy of Expanding Accountants' Liability*, 1 COLUM. BUS. L. REV. 213, 215, 228-31 (1988); Mednick, *Accountants' Liability: Coping with the Stampede to the Courtroom*, J. ACCT. 118 (Sept. 1987); Minow, *Accountants' Liability and the Litigation Explosion*, J. ACCT. 70 (Sept. 1984).[5]

In part, the rampant increase in litigation against accounting firms is due to the complexity of the certified public accountant's function and a pervasive misunderstanding of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards that some commentators have called an "expectation gap": "a difference between what the public and financial statement users believe accountants and auditors are responsible for and what the accountants and auditors are responsible for and what the the accountants and auditors themselves believe they're responsible for." Guy & Sullivan, *The Expectation Gap Auditing Standards*, J. ACCT. 36 (Apr. 1988). A related but separate reason why auditors are frequently named as defendants is that, "[f]rom [the public misperception of the auditor's duties] flows an erroneous legal supposition that [the auditor's] responsibility should be coextensive with that of the client." Minow, J. ACCT. at 77-78.

In reality, an auditor is "a watch-dog, but not a bloodhound." *In re Kingston Cotton Mill Co.*, 2 Ch. 279, 288 (1896). As the California Supreme Court recently aptly stated:

> As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their con-

5 In 1990, Laventhol & Horwath, the seventh-largest accounting firm, collapsed—the largest bankruptcy for a professional organization in United States history. While other factors contributed to the firm's demise, the overriding reason was the weight of its litigation burden. *See* McLeod, *Claims Help Sink Laventhol; Virtually All E & O Coverage Depleted*, BUS. INS., Nov. 26, 1990, at 2.

> tents. The client engages the auditor, pays for the audit, and communicates with audit personnel throughout the engagement. Because the auditor cannot in the time available become an expert in the client's business and record-keeping systems, the client necessarily furnishes the information base for the audit.
>
> * * *
>
> Thus, regardless of the efforts of the auditor, the client retains effective primary control of the financial reporting process.

Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) (citations omitted).

Because the audit is a client-controlled process, an audit "primarily tests for unintentional mistakes, not fraud." Gossman, 1 COLUM. BUS. L. REV. at 236. In fact, an audit

> provides little or no protection against management fraud, which is designed to elude discovery. Managers who commit fraud are well aware of the procedures that are likely to be followed and their limitations, and are thus in a position to minimize the likelihood of discovery during an audit.

Id.; *see also id.* at 233 ("An audit report is not designed to guarantee the accuracy of the financial statements prepared by management, but only to attest to the fairness of management's presentation.").

Apart from the misunderstanding of their role in the financial reporting process, accountants are often sued simply because they are viewed by plaintiff investors as "convenient deep pocket[s]." *See* Lochner, *Black Days for Accounting Firms*, WALL ST. J., May 22, 1992, at A10, col. 4; Mednick, J. ACCT. 118 (Sept. 1987); Galen, *Litigation Blitz Hits Accountants*, NAT'L L.J., June 16, 1986, at 1, 26, col. 1. Accountants thus face liability distinctly out of proportion to their comparative responsibility, a circumstance which "dilutes the moral force of

the law and breeds cynicism on the part of those deep pockets who are targets." *Cf.* Wright, *Why Are Professionals Worried About RICO?*, 65 NOTRE DAME L. REV. 983, 994 (1990).

Moreover, accountants face a risk of liability under the securities laws vastly disproportionate to the compensation they receive. While it is not unusual for alleged losses of members in a securities class action to exceed several hundred million dollars, the typical auditing fee for the transaction giving rise to the litigation is but a tiny fraction of that potential exposure. *See, e.g.*, Berton, *Judge Voids Big Tort Award on Price's Audit*, WALL ST. J., Dec. 17, 1992, at A3, col. 4, A6, col. 3 (noting reversal of $338 million jury verdict against accounting firm, which was more than 2,000 times the firm's annual audit fee for its client bank). Meanwhile, the insider parties, such as corporate managers who have sold their stock in a public offering, often reap a disproportionate share of the benefits of the challenged transaction. To permit these parties to pay little or nothing, while requiring accountants and other advisors to shoulder the entire multi-million dollar liability, is especially unfair.

Finally, placing the bulk of responsibility for 10b-5 violations on accountants and other professionals unfairly harms the users of professional services. If professionals doing securities work face potential 100 percent exposure for their clients' misconduct, some professionals will stop practicing in the field, and the survivors will raise their rates to cover the increased risk. Ultimately, the investing public will be required to pay the cost.

As the Seventh Circuit recognized in *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990), an overbroad extension of accountants' liability necessarily increases the costs of accounting services and thereby decreases the availability of these services. *Id.* at 629. Clients who are unable to afford the increased cost of high-quality accounting services may turn to accounting firms who are less responsible, but cheaper. *See* Kirby & Davies, *Accountant Liability: New Exposure for an Old Profession*, 36 S.D. L. REV. 576, 595 n.200 (1991).

In light of these equitable and practical considerations, the appropriateness of contribution in 10b-5 actions is beyond question. Yet opponents of contribution contend that it is not unfair to deny contribution in 10b-5 actions because liability presupposes a finding of intentional wrongdoing. *See, e.g.*, NASCAT Br. at 25-26. But that assumption does not hold where the party seeking contribution has settled before trial, which will be the case perhaps 90 percent or more of the time. *See* Point IC, *infra*. In that circumstance, there is neither a finding of liability nor, typically, any admission of wrongdoing by the settling party, who most often has settled simply to avoid the risk and cost of trial.

Moreover, even with respect to adjudicated wrongdoers, the lower federal courts have often permitted a finding of scienter predicated on something less than actual intent to defraud, such as recklessness. *See, e.g., Rolf v. Blythe, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).[6] And an adjudicated wrongdoer seeking contribution "is asserting a claim not based on the wrong, but upon the satisfaction of the wrong." Langmore & Prentice, 40 EMORY L.J. at 1068. Which defendant ultimately must pay to satisfy the wrong should be a matter of indifference to the plaintiff, in which case contribution should be allowed to prevent one defendant from having to carry an unjust burden.

Ultimately, a no-contribution rule violates the principle of equity that is a central goal of the American system of jurisprudence. No sound justification exists for abandoning this principle in actions brought under Rule 10b-5.

6 This Court has left open the question of whether recklessness or some other state of mind short of actual intent may suffice to establish scienter under Rule 10b-5. *See Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980).

B. Contribution Promotes the Policy of Deterrence.

For reasons similar to those supporting allowance of a right of contribution on grounds of fairness, the great majority of courts have concluded that a rule of contribution enhances the deterrent effect of the federal securities laws. *See, e.g., Gould v. American-Hawaiian Steamship Co.*, 387 F. Supp. 163, 169 (D. Del. 1974), *vacated on other grounds*, 535 F.2d 761 (3d Cir. 1976); *Baker v. B.P. America, Inc.*, 749 F. Supp. 840, 843 (N.D. Ohio 1990), *Globus, Inc. v. Law Research Serv., Inc.*, 318 F. Supp. 955, 958 (S.D.N.Y. 1970), *aff'd*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971). The reason is not difficult to discern: "Contribution tends to increase the diligence of potential defendants because each of them knows that he will be responsible for a portion of the damages, whether or not the defrauded investor names him in the lawsuit." 5D Jacobs, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 264.02[c], at 11-442—11-443 (2d ed. 1992). Conversely, under a no-contribution rule, the "possibility of escaping all liability—a 'sporting chance' of a type traditionally appealing to wrongdoers as a class—might cause many to be more willing rather than less willing to engage in the wrongful activity." Leflar, *Contribution and Indemnity Between Tortfeasors*, 81 U. PA. L. REV. 130, 133-34 (1932).

Indeed, for the same reason that courts have refused to allow indemnity in 10b-5 actions as a matter of public policy, they have permitted a cause of action for contribution. *See, e.g., Globus*, 318 F. Supp. at 958; *Gould*, 387 F. Supp. at 169. Were contribution not available, "those found liable for breach of a statutory obligation might escape liability as effectively as if they were entitled to indemnity." *Id.*

Petitioners argue that a no-contribution rule enhances deterrence because business managers are deterred by the risk of catastrophic loss and because contribution acts as a form of insurance. Pet. Br. at 40; NASCAT Br. at 16-18. But given the magnitude of potential damages in a 10b-5 class action, indi-

vidual corporate officers and directors are likely to view even shared liability as catastrophic. "Therefore, it is incorrect to assume that the smaller threat of a bigger penalty deters wrongful conduct more effectively than the more certain threat of a smaller penalty." Langmore & Prentice, 40 EMORY L.J. at 1080. To the contrary, "most courts and commentators have concluded that certainty of punishment is a more effective deterrent than severity of punishment, and therefore, that permitting contribution deters wrongdoing better than a no-contribution rule." *Id.* at 1074.

Even if it were provable that a no-contribution rule had a marginal deterrent impact in some circumstances—and no such proof exists—the impact of such a rule on the accounting profession would be minimal to non-existent. That is because accountants already face substantial penalties for improper conduct, the deterrent value of which dwarfs that of a no-contribution rule. Unlike most corporate insiders, accountants are "repeat players" in transactions creating potential 10b-5 liability, in connection with which they are regularly exposed to astronomical civil damages claims, potential government enforcement proceedings (both civil and criminal) and professional reputational injury.[7] These potential penalties far outweigh any benefits accountants stand to gain (such as receipt of their auditing fee) by participating in securities fraud.

Furthermore, unlike corporate insiders, accountants are subject to an extensive system of self-discipline and public oversight. For example, the Institute's bylaws require that firms auditing publicly-registered companies undergo a rigorous peer

7 The repetitive exposure to 10b-5 claims tends to be concentrated upon the six largest accounting firms, which collectively audit all but a handful of the country's largest and most prominent public companies. According to recently-published figures, the six firms audit 494 of the Fortune 500 industrial companies; 99 of the Fortune 100 largest commercial banks; and 90 percent of the publicly-traded companies in the United States with annual sales of one million dollars or more. *See* WHO AUDITS AMERICA 393-96 (Data Fin. Press, 25th ed. June 1991).

review process monitored by an autonomous Public Oversight Board ("POB") and overseen by the Securities and Exchange Commission ("SEC") through the Office of its Chief Accountant. Firms found to have engaged in flawed audits are required to undertake substantial corrective measures to improve their quality of practice. As a supplement to this peer review process, the Institute's Quality Control Inquiry Committee (QCIC), which is likewise overseen by the POB and SEC, reviews and analyzes all litigation and government proceedings alleging faulty audits of SEC registrants as well as banks and other financial institutions that file periodic regulatory reports with agencies other than the SEC. The Institute's members are required to report such litigation and proceedings to the QCIC, which then determines whether there are deficiencies in the firm's quality controls, and if so, whether the member has taken appropriate corrective measures.

In addition, accountants are governed by a Code of Professional Conduct administered by the Institute's Professional Ethics Division, which is empowered to investigate and take disciplinary action against members for violations of the Code. Accountants are also subject to discipline by state boards of accountancy, which enforce the state laws of public accountancy and impose penalties, up to and including revoking the professional's license to practice. And the SEC may bar an accountant from practicing before it if it finds that the accountant has engaged in "unethical or improper professional conduct." *See* 17 C.F.R. § 201.2(e)(ii).

Thus, accountants do not need a no-contribution rule to deter them from misconduct. By contrast, the specter of a contribution action may be a significant—and in some cases the only—deterrent to corporate insiders.

In the end, because the fairness factor runs so strongly in favor of a right to contribution, those who favor a no-contribution rule bear the heavy burden of persuasion on the question of whether such a rule would in fact operate as the greater deterrent in 10b-5 actions. Petitioners have failed to carry that burden here.

C. Contribution Does Not Discourage Settlement or Impair Judicial Efficiency.

The contention that contribution should be rejected because it discourages settlement and complicates litigation (NASCAT Br. at 18-24) is without merit. A soundly-administered contribution rule has none of the deleterious effects about which critics of the rule complain.

First, there is no convincing empirical evidence that a right of contribution discourages settlement. Langmore & Prentice, 40 EMORY L.J. at 1096. Indeed, disallowing contribution may actually discourage settlement because each defendant may refuse to settle in hopes that the plaintiff will seek recovery from the others. *Id.*

The notion that contribution inhibits settlement of 10b-5 actions is also refuted by experience. Contribution has been widely permitted in 10b-5 actions for many years, and the vast majority of such actions have in fact settled. *See* Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (concluding from empirical study that securities class action suits routinely settle for millions of dollars at a "going rate" of about 25% of the potential damages, regardless of the merits of the claims); Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 HOUS. L. REV. 769, 811 (1977) (83% of federal securities actions which were tried, dismissed or settled over seven-year period were resolved by settlement); *see also* O'Brien, *The Class-Action Shakedown Racket*, WALL ST. J., Sept. 10, 1991, at A20, col. 3 (reporting 96% settlement rate); 138 Cong. Rec. E2463 (daily ed. Aug. 12, 1992) (statement of Rep. Tauzin on H.R. 5828, Securities Litigation and Civil Justice Preservation Act of 1992) ("In fact, 95 percent or more of all 10b-5 class actions are settled, much more than the normal settlement rate for other civil cases.").

The reason for this high settlement rate is simple: Under the current system, even innocent parties are forced to settle 10b-5 suits because it is often the only rational choice. *See Blue Chip Stamps*, 421 U.S. at 739 ("Litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."). Defendants must face the fact that even if they ultimately prevail at trial, their legal expenses will be substantial. The burden of discovery falls disproportionately on defendants because they possess the bulk of the relevant information. *See Blue Chip Stamps*, 421 U.S. at 741 (noting potential for discovery process to permit a plaintiff with a largely groundless 10b-5 claim "to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence"). The risk of an enormous damage award, including the potential for punitive damages as well as treble damages on related RICO claims, must also be considered. And deep pocket defendants face the prospect of paying for the liability of other parties who settle for a disproportionately low amount.

While contribution does nothing to lessen the high overall settlement rate in 10b-5 actions, it does operate to prevent patently collusive settlements. A no-contribution rule creates an obvious incentive for plaintiffs to enter into collusive settlements with culpable, but financially strapped, corporate insiders in order to concentrate their efforts on deep pocket outside advisors who merely failed to discover the fraud. The insiders may settle for a minimal amount, secure in the knowledge that they face no further exposure for contribution, in exchange for an explicit or implicit promise to implicate their outside advisors in the alleged wrongdoing. The possibility of even more collusive "Mary Carter agreements," by which the settling defendant retains a financial stake in any recovery against the non-settling defendants, is also present. *See, e.g.*, *Elbaor v. Smith*, 36 Tex. Sup. Ct. J. 245 (Dec. 2, 1992) (declaring Mary Carter agreements void as against public policy).

Contribution thus assures that the most responsible parties will not be released from the action, at least not without payment of their fair share of any liability.

In *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983), the Fifth Circuit emphasized the anachronistic nature of a no-contribution rule in light of the "evolution of multiparty litigation involving class plaintiffs, numerous defendants, vast monetary claims, lengthy trials and enormous litigation costs." *Id.* at 558. As the court noted:

> Persons injured by the willful torts or deceit of others are entitled to full redress but should not be able to play one defendant against another as a gambit. Although the law favors compromise as a means of ending litigation, the type of settlement that is reached on the basis of the denial of contribution neither terminates the litigation nor furthers the goals of efficient court administration.

Id.

Similarly, in *Reliable Transfer*, this Court adopted a rule of contribution and rejected the argument that it should

> continue the operation of an archaic rule because its facile application out of court yields quick, though inequitable, settlements, and relieves the courts of some litigation. Congestion in the courts cannot justify a legal rule that produces unjust results in litigation simply to encourage speedy out-of-court accommodations.

421 U.S. at 408.

Opponents of contribution also argue that contribution complicates litigation, thereby overburdening plaintiffs and the judicial system. *See* NASCAT Br. at 22-24. The short answer to this argument, as this Court has already stated, is that ease of administration does not justify an unfair rule. *Reliable Transfer*, 421 U.S. at 408. For example, while a comparative negligence rule arguably is more difficult to administer than a rule

of contributory negligence, that has not prevented the overwhelming majority of jurisdictions from adopting comparative negligence in tort cases. *See* Roszkowski & Prentice, *Reconciling Comparative Negligence and Strict Liability: A Public Policy Analysis*, 33 ST. LOUIS U. L.J. 19, 31-32 nn.58-60 (1988).

In any event, any asserted efficiencies of a no-contribution rule in 10b-5 actions would be minimal at best. Most Rule 10b-5 claims are coupled with pendent state law claims as to which rights of contribution already exist, and thus the court will have to resolve issues of damage apportionment among defendants anyway. The same is true when, as is frequently the case, a claim under Section 11 of the Securities Act, which permits contribution (*see* 15 U.S.C. §77k(f)) is brought together with a claim under Rule 10b-5. Moreover, the typical 10b-5 contribution claim is resolved among defendants and impleaded parties in the context of an already-existing action; in such cases, the contribution issues can be determined simply by submitting interrogatories to the jury, with little expenditure of additional time and effort. *See* Fed. R. Civ. P. 49.

II.

PROPORTIONAL FAULT IS THE BEST APPROACH TO THE ALLOCATION OF DAMAGES IN 10b-5 ACTIONS.

Although the question of how damages should be allocated among defendants seeking contribution is not before the Court, *amicus* NASCAT has urged the Court not to create a right of contribution without giving lower courts and litigants some guidance as to the contours of such a right. NASCAT Br. at 27. Without agreeing that the right of contribution need be fully defined at this juncture, the Institute offers the following views in the event the Court elects to consider the matter.

At least two separate questions are presented regarding the workings of a right of contribution: First, in contribution generally under Section 10(b), how is liability to be apportioned? And second, where some but not all defendants settle before trial, and further contribution claims against the settling defendants are barred, what method should be utilized for reducing the damages that may be collected from the remaining defendants? The Institute submits that with respect to both questions, a proportional or comparative fault method of apportionment is the best approach because it is most consistent with the policies behind the right of contribution.

First, with respect to the apportionment of liability generally between jointly liable parties who may seek contribution, a proportional fault approach is clearly superior to the other available alternative—the *pro rata* method. Under the *pro rata* method, damages are simply divided equally among all responsible parties, while the proportional fault approach allocates liability according to each party's percentage of fault as determined by the finder of fact.

This Court has already expressed its view that a proportional fault approach is preferable to a *pro rata* method of damage apportionment, stating in *Reliable Transfer* that "[a] rule that divides damages by degree of fault would seem better designed to induce care than the rule of equally divided damages, because it imposes the strongest deterrent upon the wrongful behavior that is most likely to harm others." *See* 421 U.S. at 405 n.11. The lower courts have also overwhelmingly rejected the *pro rata* approach because of the unfairness inherent in automatically apportioning damages evenly among persons found liable, particularly in 10b-5 actions where there are numerous parties with varying degrees of culpability, some of whom are only remotely involved in the alleged fraud. *See Gould*, 387 F. Supp. at 171; *Smith v. Mulvaney*, 827 F.2d 558, 561 (9th Cir. 1987); *McLean v. Alexander*, 449 F. Supp. 1251, 1273 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) (*pro rata* rule is "characterized by more mathematical than judicial integrity.").

The artificial nature of the *pro rata* rule also makes it more difficult for a plaintiff to settle cases involving multiple defendants with widely varying culpability. *See* Adamski, 66 IOWA L. REV. at 560. Minimally culpable defendants are unlikely to settle for as much as an amount based on their *pro rata* share of total damages, while major defendants are unlikely to be willing to pay more than their *pro rata* share.

Thus, if the Court is inclined to reach the question, it should define the 10b-5 right of contribution to include the proportional fault method of apportionment, consistent with the Court's statement in *Reliable Transfer* that comparative fault should be the rule "whenever possible." 421 U.S. at 411.

As for the second and related question of how the plaintiff's damages should be reduced at trial following a partial settlement, the debate is essentially between a *pro tanto* approach, under which any judgment against non-settling defendants is reduced by the dollar amount of the settlement, and the proportional fault or "*Kaypro*" approach, so named after the decision in *Franklin v. Kaypro Corp.*, 884 F.2d 1222 (9th Cir.), *cert. denied*, 111 S. Ct. 232 (1990). Again, the proportional fault method is clearly the better approach. *See* Langmore & Prentice, 40 EMORY L.J. at 1098; *accord* Wolff, *Allocation of Damages Under the Federal Securities Laws*, 60 WASH. U. L.Q. 211, 245-46 (1982); *Alvarado Partners, L.P. v. Mehta*, 723 F. Supp. 540 (D. Colo. 1989), *appeal dismissed as moot*, 936 F.2d 582 (10th Cir. 1991).

In many 10b-5 actions, a *pro tanto* approach is virtually tantamount to a rule of no-contribution at all. For example, assume that in a shareholder class action the plaintiff's loss is $100 million and the former corporate officers and directors are responsible for 70 percent of that loss but collectively settle for only $1 million. Assume further that the corporation's outside accountants and lawyers are each 15 percent responsible. After settlement, the accountants and lawyers may have to make up the remaining $99 million even though, under equitable principles, their fair share would be only $30 million collectively.

The *pro tanto* reduction of $1 million has the same practical effect in such a situation as no contribution at all.

The *pro tanto* rule also retains the same dangers of collusion that are present in a no-contribution system. Since the plaintiffs will be able to collect their total loss, less the settlement amount, from the remaining defendants, they have nothing to lose by accepting an inadequate settlement from more culpable, but less solvent, parties who can be enlisted to help "go after" the deep pockets. *See River Garden Farms, Inc. v. Superior Court*, 103 Cal. Rptr. 498, 503 (Ct. App. 1972) ("In a multi-party case, the threat of an unshared judgment against the last remaining defendant—diminished only by meager settlements with his eager fellows—permits a plaintiff to create acute financial pressures bordering on extortion."); *Kaypro*, 884 F.2d at 1230 (under *pro tanto* scheme "plaintiffs could effect low settlements with defendants who had limited resources, and thereby *force* wealthier defendants to pay more than if all parties proceeded to trial") (emphasis in original). For the same reason, a *pro tanto* rule potentially diminishes the deterrent effect of the securities laws by allowing the primary wrongdoer to escape with a minimal settlement payment. *See* Adamski, 66 IOWA L. REV. at 551.

In theory, these dangers can be minimized by requiring the court to determine that the partial settlement was fair and in good faith. *See, e.g., Nelson v. Bennett*, 662 F. Supp. 1324, 1338-39 (E.D. Cal. 1987). But since a good faith hearing generally takes place far in advance of trial, and before the evidence is heard, the court cannot determine that the settlement, even if made in good faith, will not prejudice the non-settling parties by requiring them to pay a far greater share of the judgment than would have been required if all defendants went to trial. Adamski, 66 IOWA L. REV. at 550; *Kaypro*, 884 F.2d at 1230. And by requiring a good faith hearing—which is unnecessary to protect non-settling defendants under the proportional fault rule—the alleged efficiencies of the *pro tanto* rule are largely dissipated. *See id.*; *Alvarado Partners*, 723 F. Supp. at

553. In sum, "[t]he encouragement of settlements achieved by the *pro tanto* approach thus comes at too high a cost to the principles of fairness in the apportionment of damages intended to be furthered by recognition of a right to contribution." Adamski, at 551; *see Reliable Transfer*, 421 U.S. at 408.

Under the proportional fault approach, non-settling defendants are barred from further rights of contribution from the settling defendants. At trial,

> the jury is asked not only to determine the total dollar damage amount, but also the percentage of culpability of each of the nonsettling defendants as well as that of the settling defendants. Nonsettling defendants as a whole will then be required to pay the percentage of the total amount for which they are responsible. The nonsettling defendants will be jointly and severally liable for that percentage, and will continue to have rights of contribution against one another.

Kaypro, 884 F.2d at 1231. The *Kaypro* rule thus satisfies the deterrent goal of punishing each wrongdoer, ensures that the equitable goal of contribution will be met, and encourages settlements by assuring that settling defendants will not be exposed to further risk. *Id.* It also removes the possibility of collusion since it is unlikely that a plaintiff will intentionally make an inadequate settlement with a highly culpable wrongdoer, knowing that any judgment against the remaining defendants may be reduced by the percentage liability of the settling wrongdoer.

The principal objection to the *Kaypro* rule advanced by its opponents is that plaintiffs supposedly "forfeit their right to be made whole when liability is established after trial." NASCAT Br. at 18. This is untrue. Any diminution of the judgment under the *Kaypro* approach is due entirely to plaintiff's voluntary decision to settle for an amount that proves to be inadequate. What *Kaypro's* critics really are complaining about is that the proportional fault approach places the risk of an inadequate settlement upon the plaintiff rather than the non-settling defen-

dants. *See* Davis, *Multiple Defendant Settlement in 10b-5: Good Faith Contribution Bar*, 40 HASTINGS L.J. 1253, 1276 (1989); *In re Jiffy Lube Sec. Litig.*, 927 F.2d 155, 161 (4th Cir. 1991) ("[P]laintiffs bear the risk of a 'bad' settlement under the 'proportionate' rule, while under the '*pro tanto*' rule the risk passes to the non-settling defendants. . . ."). Yet it is not unfair to place this risk on the plaintiff, since it is the plaintiff, after all, who has chosen to settle for an amount deemed to be in its best interests. If plaintiff chooses to settle cheaply to avoid the uncertainties and costs of litigation against a particular defendant, or to obtain a "war chest" to fund the litigation, that is plaintiff's choice. But non-settling defendants, who are not parties to this private bargain, should not be required to bear the risk that plaintiff's choice will later prove unsatisfactory. *See Alvarado Partners*, 723 F. Supp. at 553.

The assertion that the *Kaypro* rule necessarily prevents plaintiffs from being made whole also ignores the possibility that a plaintiff under this rule actually may end up receiving more in the aggregate than it would have if all defendants had gone to trial. This will be the case whenever the settling defendants pay a sum exceeding their proportional share as determined at trial.[8]

Critics of the *Kaypro* rule also complain that it provides non-settling defendants an "empty chair" defense which results in lower judgments. Pet Br. at 39; NASCAT Br. at 22. But this "defense" is a double-edged sword. Securities class action plaintiffs typically allege, and seek to prove, a common conspiracy or scheme to defraud in which all defendants partici-

8 To prevent such a windfall, and avoid violation of the "one satisfaction" rule (by which the plaintiff is not entitled to receive double compensation for the same injury), the optimum contribution bar rule is a "capped" comparative fault approach which reduces the judgment by the settlement amount or the settling defendants' percentage of fault, whichever is greater. *See First Fed. Sav. & Loan Ass'n v. Oppenheim, Appel, Dixon & Co.*, 631 F. Supp. 1029 (S.D.N.Y. 1986) (applying N.Y. Gen. Oblig. L. § 15-108); Davis, 40 HASTINGS L.J. at 1276-78.

pated. If non-settling defendants engage in too much finger pointing at the absent "ringleader" (NASCAT Br. at 22), they only end up implicating themselves and increasing the odds of a plaintiff's verdict. Nor is plaintiffs' counsel forced to defend the conduct of the settling defendants (NASCAT Br. at 28); plaintiff's first and foremost incentive remains to establish liability on the part of the defendants at trial, which is usually best accomplished by asserting that they were participants in a common scheme to defraud. If anything, proof of this scheme is easier when the settling defendants are no longer present to deny wrongdoing. With the settling defendants gone from the scene, plaintiff can train his sights on the remaining defendants and sharpen the focus of the trial to emphasize their alleged misdeeds. For example, if only underwriter defendants are remaining, plaintiff's counsel can put on a case of underwriters' liability without having to expend time and limited attorney resources trying to prove a case against accountants, attorneys or individual managers, each of whom would have had separate and vigorous representation at trial. Meanwhile, under this example, the underwriter defendant will lose the benefits of a unified front that would have been present had all defendants gone to trial. These benefits include the potential value-added by other defense counsel who may be more experienced or better prepared for trial, particularly on certain aspects of the defense case.

NASCAT also argues that *Kaypro* effectively precludes partial settlements, particularly with less solvent parties, by making them too costly for plaintiffs to bear. NASCAT Br. at 20. Putting aside the unreality of the hypothesis that any defendant would ever be willing to pay "everything they own in settlement," *id.* at 22 (why do so, when one could do no worse, and possibly much better, by going to trial?), the argument lacks any merit. The short answer to this argument is that the *Kaypro* rule inhibits only settlements that are unfair to non-settling defendants, and it is no indictment of the rule to say that it produces this result. Beyond this, non-settling defendants still have a strong incentive to settle after a partial settlement has

been achieved, since no defendant wishes to become the sole focus of the plaintiff's case (and the jury's attention) at trial. Once plaintiff starts the ball rolling by settling with some but not all defendants, that increases the pressure on non-settling defendants to fall in line and reach a global settlement.

Moreover, the contention that *Kaypro* precludes settlements is demonstrably untrue. In the Ninth Circuit, which follows the *Kaypro* rule, both global and partial settlements continue to be achieved with regularity. *See, e.g., In re U.S. Grant Hotel Assoc. Ltd. Sec. Litig.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,703 (S.D. Cal. Nov. 6, 1990) (reporting approval of partial settlement); *In re Precious Metals Dealers Litig.*, No. 90-5124 (C.D. Cal. Feb. 24, 1992) (partial settlement reported in 15 Class Action Rep. 145 (1992)); *In re Rykoff-Sexton Sec. Litig.*, No. 90-0689 (C.D. Cal. Nov. 13, 1991) (settlement reported in 15 Class Action Rep. 145 (1992)); *In re Xoma Corp. Sec. Litig.*, Nos. 92-2252 & 92-0687 (N.D. Cal. May, 20 1992) (settlement reported in 15 Class Action Rep. 147 (1992)); *In re Brichard Sec. Litig.*, No. 87-2987 (N.D. Cal. Mar. 27, 1991) (partial settlement reported in 15 Class Action Rep. 152 (1992)); *Berley v. Sculley*, No. 91-20270 (N.D. Cal. Feb. 27, 1992) (settlement reported in 15 Class Action Rep. 153 (1992)); *Arata v. Nu Skin Int'l, Inc.*, No. 91-2811 (N.D. Cal. Jan. 31, 1992) (settlement reported in 15 Class Action Rep. 158 (1992)); *Alfus v. Pyramid Tech. Corp.*, No. 89-20184 (N.D. Cal. Feb. 20, 1991) (settlement reported in 14 Class Action Rep. 525-26 (1991)); *In re Cineplex Shareholders Litig.*, No. 89-2461 (C.D. Cal. 1991) (settlement reported in 14 Class Action Rep. 526 (1991)); *In re Beverly Hills Sav. & Loan Ass'n Sec. Litig.*, No. 85-3157 (C.D. Cal. June 13, 1991) (settlement reported in 14 Class Action Rep. 314 (1991));[9] *In re Technical Equities Fed. Sec. Litig.*, No. C-

9 The *Beverly Hills* case illustrates how a case can settle partially, and then globally, under the *Kaypro* rule. Subsequent to a partial settlement between the plaintiffs and the officer and director defendants, a global resolution of the litigation was reached to include the underwriter, law firm and accounting firm defendants.

86-20157 (N.D. Cal. Nov. 17, 1989) (settlement reported in 14 Class Action Rep. 315-16 (1991)); *Tonnemacher v. Sasak*, No. 89-0201 (D. Ariz. Apr. 15, 1991) (partial settlement reported in 14 Class Action Rep. 316 (1991)); *In re Digital Sound Corp. Sec. Litig.*, No. 90-3533 (C.D. Cal. Jan. 31, 1991) (settlement reported in 14 Class Action Rep. 330 (1991)).[10]

Furthermore, the asserted efficiencies of a *pro tanto* contribution bar rule, in comparison with a rule of relative culpability, are uncertain at best. Unlike the *pro tanto* rule, the *Kaypro* approach does not require a separate hearing to determine the fairness and good faith of a partial settlement, since a proportional fault rule adequately protects non-settling defendants from collusive or inadequate settlements. *See In re Jiffy Lube Sec. Litig.*, 927 F.2d 155, 160 & n.3 (4th Cir. 1991). The good faith hearing, if it is to serve its intended purpose, " 'means bogging down the settlement process in a miniature trial before trial.' " *Kaypro*, 884 F.2d at 1230 (quoting *Donovan v. Robbins*, 752 F.2d 1170, 1181 (7th Cir. 1985)). That would negate many of the benefits of settlement. 884 F.2d at 1230.[11]

10 Indeed, in *Kaypro* itself, the original non-settling defendants were able to agree to a global settlement within a short time after finalization of the Ninth Circuit's decision without additional discovery. After the company's officers and directors had originally settled for approximately $9.25 million, the remaining accountant and underwriter defendants settled for $300,000 each—a settlement that would not have been possible under a *pro tanto* regime.

11 It may be argued that in a securities class action, the court will be required to conduct a fairness hearing anyway pursuant to Fed. R. Civ. P. 23(e), even under the proportional fault rule. But such a hearing need not concern itself with the relative fault of the wrongdoers or the evidence necessary to make that determination. *See In re Jiffy Lube*, 927 F.2d at 160 ("A separate hearing on fairness from the perspective of the non-settling defendant is not required unless the district court chooses to adopt the '*pro tanto*' method of setoff."); *Smith v. Mulvaney*, 827 F.2d at 562 (describing different nature of the two proceedings). Moreover, in non-class action 10b-5 cases, no fairness hearing at all would take place under the proportional fault approach.

In sum, the claimed efficiencies of the *pro tanto* rule are at best marginal, and in any event do not outweigh the other clear advantages of the proportional fault rule. Consistent with the rationale for the right of contribution itself, the proportional fault rule serves the goal of fairness, promotes the policy of deterrence, and encourages appropriate settlements of actions.

CONCLUSION

For all of the foregoing reasons, the Court should recognize a right to contribution under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

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